ESO 250

Financing of Dairy Cooperative Facilities and Marketing Programs

9th Ohio Dairy Seminar

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Financing of Dairy Cooperative Facilities and Marketing Programs

The 9th annual Dairy Seminar, sponsored jointly by the Ohio Milk Producers Federation, the Ohio Farm Bureau Federation, and the Ohio Cooperative Extension Service, was held on March 4-5, 1975. The focal point of this seminar concerned the financing problem as faced by dairy marketing cooperatives. Because of his review of major dairy cooperatives in the Northeast that have faced serious financing questions, the Program Committee asked Mr. William Monroe, Farmer Cooperative Service, U.S. Department of Agriculture, to serve as the key resource person for the seminar. A response panel including Eldie Vickrey, General Manager, Miami Valley Milk Producers Association, and Robert Brewer, President, Cincinnati Cooperative Milk Sales Association provided their reactions to Mr. Monroe's presentation.

This monograph reports Mr. Monroe's remarks together with the responses of Mr. Vickrey and Mr. Brewer. The information should be particularly useful to members of dairy marketing cooperatives, directors of dairy cooperatives, and management of these cooperatives as they face financing questions on a continuing basis.

The Dairy Seminar pursued other issues in milk marketing during its sessions, but only the financing topic has been recorded.

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FINANCING OF DAIRY COOPERATIVE FACILITIES AND MARKETING PROGRAMS

William J. Monroe
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It is a pleasure to be here today and to have the opportunity to discuss financing of cooperative facilities. The assigned topic is very appropriate at this time for two reasons. First, cooperatives are accepting more and more of the responsibility for providing the facilities needed to market milk further down the line to the consumer; and this is requiring large amounts of capital. Second, cooperatives, as we have read and heard, are having their financial problems.

Before we look at the problems and needs of cooperative facility financing in the dairy industry, we should look very briefly at financing of cooperative facilities in general. Such financing requires relatively large amounts of both debt and equity capital. Equity capital provides the necessary element of ownership and control. It is the risk capital. It serves as a buffer to absorb operating losses and any shrinkage in asset value.

Members contribute equity to their cooperatives by (1) investing some or all of their savings or margins; (2) purchasing capital stock or other securities; and (3) investing capital retains.

The invested savings method is used most extensively. About three out of every four dollars of equity capital have been acquired by cooperatives from savings distributed as patronage refunds and reinvested by patrons.

Marketing cooperatives often use the third method-per unit capital retains. More than a third of the total equity of marketing cooperatives has been contributed by patrons through this method.

The financing needs faced by dairy cooperatives can be appreciated by noting their scope of involvement in the milk industry.

In 1967 cooperatives were furnishing the facilities for producing about 75 percent of the non-fat dried milk, 65 percent of the butter, 30 percent of the American cheese, 15 percent of the cottage cheese, 10 percent of the packaged fluid milk, and 5 percent of the ice cream produced in the United States. We believe these percentages have increased during the past 8 years. In an effort to determine what cooperatives are doing lately, Farmer Cooperative Service (FCS) recently surveyed the receipts and utilization of all the dairy cooperatives in the United States. We believe that cooperatives are not only making more manufactured products today than they did in 1967 but are also processing and packaging more fluid milk. It appears to us that the processing and packaging of fluid milk is being taken over more and more by chain stores and dairy cooperatives. It also appears that cooperatives are getting more and more into the food processing business.

If these two trends continue, the cooperatives' needs for additional financing will grow astronomically. Where will these cooperatives get this money and what new problems will this bring to the management of cooperatives?

Now, if we see cooperatives in the future as large integrated, multi-purpose, organizations with multi-product, multi-plant operations, then we may want to look at some of the problems these types of cooperatives have had in the past to see what may be in the future.

There are several large multi-plant, multi-product manufacturing cooperatives with significant manufacturing and bottling operations. A few of these are new to the industry and their histories are short. Some appear to be quite successful.

But all is not sweet and light. Over the past year or two several cooperatives that integrated vertically into the packaged fluid milk business have had to retreat to live and fight another day.

We have also seen over the past year several relatively large multi-product, multi-plant cooperatives that were for years eminently successful come upon hard times. Two of these are in New York and Pennsylvania. Perhaps we might learn something from these that would be helpful to others.

I'm sure all of you are familiar with the problems of the New York and Pennsylvania cooperatives. Much has been written about them in the papers, some true and some fiction.

I don't want to set out these two cooperatives as bad examples. Their situations are more the results of their marketing environment than of any improper action or poor judgments. They had had a history of very successful operations. It has only been the past few years that they have had financial problems.

What were the difficulties that created the financial problems which finally erupted into headlines? Are these two cooperatives only the first of many others to follow or was each of their situations one of a kind, unique in origin, singular in effect, inevitable in result? In other words, do we have anything to worry about as directors, managers, or educators in terms of cooperative structure, operation or finance? Are cooperatives equipped financially to take on the enlarged function of marketing their members' milk in a changing and highly competitive industry?

We in FCS have worked and are presently working with these two cooperatives and are quite familiar with their operations. What I have to say today regarding them can be gleaned from their published information. I will be unable to discuss any problem or provide any information that we have received in confidence.

Although there are differences in the operations of these two cooperatives, there are similarities in most respects. First, let us describe the New York cooperative's situation by listing those factors which we believe had a significant bearing on its problem. These factors are:

1. The New York cooperative marketed milk in several Federal and State Order markets in the Northeast. The largest portion of its milk is marketed in New York-New Jersey Federal Order 2. This market is a highly competitive market for both raw fluid milk and packaged milk. The cooperatives in this market lack the unified marketing action that prevails in other large markets. Cooperatives in the New York market had until recently looked first to the Federal Order to solve most of their marketing problems rather than through coordinated action. By so doing they have solved some of their short-run problems only to have created more difficult long-run problems. One example was the problem of accounting for and pricing milk with the advent of bulk tank assembly. Farm point pricing was initiated as a solution and the cooperative became directly responsible for costs of hauling its members' milk. Although handlers and cooperatives were authorized to deduct a charge for this hauling, cooperatives did not put this charge into effect. Consequently, the prevailing Order 2 philosophy of "free hauling" for producers has magnified the New York cooperative's other problems in obtaining break-even operations of its plants.

2. The New York cooperative has a relatively small share of the total Order 2 market. Therefore, it is unable by itself to greatly influence the terms of sales of its milk. Cooperatives have about 69 percent of producers in the New York-New Jersey market. Non-members in Order 2 have increased between 2 and 3 percent in the past two or three years.

3. The New York cooperative packaged and sold a large portion of its own milk. It marketed packaged fluid milk throughout the states of New York and New Jersey. It operated several milk processing plants and large numbers of distribution facilities. In the late 1960's it entered the greater Northeast milk market with the purchase of a Boston milk company. The New York

cooperative never was able to bring that operation into a profitable position. The losses from this operation drained away needed operating capital from other operations.

4. The New York cooperative manufactured its milk not needed for Class I use into a large variety of manufactured products. This required several large investments in processing and manufacturing facilities. The New York cooperative was responsible along with NEDCO for the market clearing function for the entire market. Both cooperatives have experienced difficulty in operating these supply balancing plants on a profitable basis. Further, because of lack of coordination in the market they were unable to recover these losses with over-order prices. In addition, the New York cooperative did not have enough surplus milk in any one area to assure a profitable year-round, high-volume manufacturing plant to offset losses in its butter-NFDM operation.

5. The New York cooperative, as did most of the cooperatives in the Northeast, paid producer-members competitive Federal Order prices for milk rather than operate a net pool. I will enlarge on the significance of this policy later.

6. The New York cooperative's capital structure was based on per unit capital retains and invested savings or margins. These were evidenced by Certificates of Indebtedness and Certificates of Investments with a fixed due date. These certificates carried a competitive interest rate. Further, the New York cooperative maintained a market for its equity certificates so that farmers could get their money out of them prior to the due date.

7. In 1973, two New York cooperatives organized CMA to perform their combined marketing activities in Order 2 with respect to (1) farm-to-plant milk hauling, (2) quality control field service, (3) raw milk sales, and (4) supply balancing and surplus milk disposal.

We recognize the problems in the New York cooperative's operations, but we believe that it properly has accepted the role of being a full service cooperative in the market. We also recognize that costs of providing full service to members cannot always be covered by the market price of milk and milk products.

What were the consequences of the practices and policies outlined? The consequences were consistent operating losses of varying magnitudes for several years, culminating in a serious cash shortage and a severe financial situation.

Why wasn't the New York cooperative able to make the adjustments in operations needed to correct its downward trend in financial condition? I believe that it did not adjust sooner because, first, the farmer-members did not recognize the significance of the problem and, second, management believed that actions taken to improve operating efficiency would eventually offset the losses. In the late 60's and early 70's the cooperative's first reaction to the losses was to try to correct them through improved efficiency in operations. The cooperative did take several steps of consolidating operations and closing plants but the cooperative was unable to create enough efficiencies to break even. Therefore, deficits continue.

It is questionable whether any full service cooperative servicing such a large, diverse market as Order 2 could ever create efficiencies in operations to fully cover costs. Without over-order prices it is virtually certain a loss position would continue.

The major policy that has created the financial problem for the New York cooperative as distinguished from its operating or marketing problem-- is the one of paying producer members a competitive price for milk regardless of the ability of the cooperative to return that price. Such a policy is a trade-off between impaired equity versus higher current cash returns.

Although I believe this to be unwise policy, I can recognize the New York cooperative's reasons for maintaining it through the years when the losses occurred. The cooperative officials argue, with some justification, that a reduction in members' pay price for milk relative to other cooperatives members' pay price from other cooperatives or other handlers pay price would cause them to lose membership and volume. This in turn would place a heavier burden on the remaining members and cause further losses in membership.

My major argument against following a policy of overpaying producers is that this plan hides from members the true significance of other operating and marketing policies. As long as farmers are receiving a competitive price for their product, they may be reluctant to demand and support changes in operations needed to eliminate the losses. Although the aggregate equity of the cooperative is visibly impaired, farmer members' impairment of individual equity is less visible. Consequently, members are slower to advocate adjustments in policies needed to correct their problems, and management hopes that future earnings will be available to offset these unallocated losses. This is risky.

When farmer-members are not asked or are not willing to provide adequate capital, a cooperative is forced to borrow money to offset losses and to maintain working capital. The additional borrowing adds to the total cost of the operations and, if marketing conditions or operating procedures are not changed, losses will be magnified. The cooperative is then less and less able to operate profitably due to the higher interest costs. This is essentially what occurred in the New York cooperative. The cooperative recognized that this was becoming a serious problem. In October, 1974, its treasurer stated, "The interest we pay . . . is one of the most important factors that has put red ink on our books." He further stated the problem: "No business could be expected to operate successfully if, on the first day of each year, it faced the necessity of earning 11 cents a hundredweight on all of its milk marketed before it could begin to pay its other expenses and earn a profit."

In 1974, the cooperative made three major policy decisions that tell us a great deal in terms of what they believed to be the basic cause of their financial problem. The New York cooperative decided to: (1) Pay farmers on a pool basis, that is, pay farmers only what the cooperative could earn from the sales of products less costs--in fact, they assessed producers for past overpayments. (2) Change financing from a totally revolving, interest-bearing capital structure to a partial permanent capital structure, whereby capital is to be revolved at the discretion of the Board. (3) Institute a profit-oriented operating policy under which each major department or product will have to pay its own costs and a share of the overhead. The cooperative believes these three policies will stop the financial drain on the cooperative and will bring it into a financially sound and viable marketing organization again.

If we look at the Pennsylvania cooperative we find that many of the same situations existed there as in New York.

1. The Pennsylvania cooperative's operations were similar to the New York cooperative's except that since 1969 it did not market raw fluid milk. Its manufacturing operations were concentrated in one plant where the New York cooperative had several plants.

2. The Pennsylvania cooperative processed, packaged and sold a large proportion of its own milk in three plants. Presently it has two bottling plants. It also had management contracts with two other processing cooperatives. The Pennsylvania cooperative's operation was first geared to selling

mainly on retail routes. Soon, after acquiring some additional facilities and after substantially remodeling them to fit retail route selling, it changed its marketing strategy to emphasize sales through chain stores. Chain store selling is highly competitive and can demand price concessions. In order to compete, a plant must have a very efficient operation. In 1974, it had just completed remodeling its Southeast Pennsylvania plant to gear it to the wholesale chain store market.

3. In early 1974, the Pennsylvania cooperative had completed an extensive building program in its manufacturing operations. It added a cheddar cheese operation, which required a greater volume of milk than was available from members and necessitated paying premiums to other sources to get the needed volume.

4. In 1968, the Pennsylvania cooperative changed from paying producers on a pool basis to paying competitive prices.

5. The Pennsylvania cooperative's capital structure earlier was based on per unit retains and reinvested earnings. Later these equities were converted into cumulative, interest bearing, preferred stock. This stock is held by members and non-members and pays a competitive rate of interest. One of the difficulties of having a cooperative's equity capital held by non-members is that non-members are concerned with returns on capital rather than services rendered and members may be less concerned with the operations than they should be.

Most of what I said regarding the New York cooperative also applies to the Pennsylvania cooperative. The Pennsylvania cooperative's early actions to correct its problems were very similar to the New York cooperative's. Finally, the Pennsylvania cooperative has taken the same three policy positions regarding paying farmers, operating plants, and financing its organization.

What lessons can we learn from the experiences of these two cooperatives? I believe there are several major lessons to be learned. They are:

1. Full service cooperatives that process and manufacture a significant portion of members' milk needed a substantial portion of its equity in permanent capital without a due date. Dividends or interest should be paid only at the discretion of the Board of Directors when financial circumstances justify. We recognize that capital must earn its due and, further, we recognize the problem of fairness among members with different levels of investment when interest is not paid. However, one may argue, as one cooperative leader did when asked whether interest was to be paid on its stock, that no interest was to be paid in <u>cash</u>. He said members will receive interest and/or dividends on these invested funds in the form of higher prices through better utilization of the milk supply and higher prices through greater flexibility in plant operations.

2. Cooperatives must operate on the pool basis, paying farmers the residual after all costs are deducted from income. Exceptions to this policy should be made only in rare situations.

3. Expansion programs should be undertaken only after detailed cost-benefit analyses have been made and then these programs should be kept under tight cost control. Although we believe that cooperatives will do more processing and packaging of fluid milk, any cooperative contemplating getting into this type of operation must take a long hard look at it. The marketing of packaged fluid milk is highly complicated and should be undertaken only if cooperatives are willing to acquire the expertise to successfully plan and manage it. Even if a cooperative is now successfully marketing packaged milk in one market, that does not mean necessarily it can market successfully in another market.

4. Cooperatives should operate under the policy that all major departments or functions must contribute to the overhead of the organization.

5. Cooperatives should maintain a timely, detailed accounting and information system which provides management with an up-to-date, accurate situation report.

6. A re-evaluation should be made of any revolving fund in which a particular portion of the capital is revolved on a predetermined basis.

Can these cooperatives as well as others provide the large amounts of future capital necessary by using the old methods of revolving fund financing or are new ways of financing going to be required?

I'm sure that new ways of financing will be found. Investors other than farmers will be providing some of the financing. But when we look at the uniqueness of cooperatives we know that one cannot stray far from the principle that the users must furnish a substantial part of the capital. If farmers are going to control their organization they must also furnish the equity capital. Where your money is, that is where your heart and head will be.

I believe that cooperatives can achieve adequate financing in the future if they have a balance of the following financing methods.

1. A base capital plan - a permanent capital program in which, after total capital needs are determined, each member or patron contributes a net amount of equity capital in proportion to his use of the cooperative and receives no interest. This is to provide a degree of fairness in terms of investment.

2. A traditional revolving fund plan in which each year, at the discretion of the board, a portion of the oldest equity capital is returned to members.

3. A permanent capital fund in which interest is paid annually on equity capital, but date of redemption is at the discretion of the board of directors. Level of investment by individual members may vary considerably.

4. Borrowed capital from lending institutions, with the Bank for Cooperatives being the major lender.

5. Special purpose financing - such as industrial revenue bonds or lease financing.

6. For some of the larger cooperatives - leveraged leasing.

I don't pretend to know what a proper balance of these types of financing should be. I suspect that the proper balance would be somewhat different for each cooperative. As cooperatives get larger and capital needs increase, members may have to shift some of the risk to outside investors. The use of leverage can result in a favored position for cooperative membership, but certainly for only as long as the cooperative is able to realize a greater return on its assets than it pays interest on debt.

In closing I would emphasize five major considerations which are very important for dairy cooperatives in planning or adjusting their financial structure.

1. They must generate more permanent capital to replace or supplement traditional revolving types of capital.

2. They must assure that the member-user provides the major portion of equity capital.

3. They must maintain equitable membership participation in providing equity capital.

4. They should maximize, within strict limits, financial leverage.

5. They must maintain a sound financial structure by - operating efficiently, and paying members only the pool value of milk.

6. Directors of cooperatives must take care in seeing that the organization does not outgrow the capabilities of its management.

Response of Eldie Vickrey, General Manager
Miami Valley Milk Producers Association

It is a pleasure to appear on the Dairy Seminar program and to work with Mr. Monroe. I could merely say I agree with the statements Mr. Monroe made and sit down; however, I think you expect me to do a little more than that. Mr. Monroe cited the operation of two dairy cooperatives in the Northeast and some of the problems that have developed with which they have struggled the past several months. While some of the problems might be unique to those coops and the area in which they operate, they certainly could develop and become identical problems in other areas.

The remarks that I make will, by necessity, be drawn from my experience with cooperatives with which I have worked and particularly Miami Valley Milk Producers Ass'n. I believe a few things are very basic and very necessary if a cooperative is going to survive and build a strong, viable organization in these times. A coop must be soundly financed and a substantial portion of the capital must be contributed by its members. At a recent meeting of Yankee Milk, their president, Louis Longo, made the statement that he felt that the equity capital provided by its members should be at least 35% and Yankee Milk is currently at 17%; and therefore members were being asked to increase the capital contributions. It is my opinion that 35% is the very minimum and if the rate of inflation the past couple of years continues, we might well need to increase to 50%. It is always a matter of concern to the Board of Directors as to the best method of financing the coop. Some of the coops have set a certain amount of capital deduction per cwt. of milk while others have established a percentage of the gross milk check as the capital deduction. It seems to me that a percentage basis is the most equitable means, because as the milk price moves up or down then the contribution maintains the same relationship, while a flat amount per cwt. does not and in some cases we find the contributions being the same with a blend price of better than $9 as when the blend price was $4.50. Regardless of the means of obtaining capital deductions, they would be evidenced to the membership by certificates, which in our case we call Certificates of Indebtedness. These are revolving certificates which have a set period of time at which they will be redeemed. In the case of Miami Valley Milk Producers Ass'n the certificates stipulate that they will be revolved in 15 years and we have been revolving them on a 7 year basis. One of the advantages and strengths of a coop is the revolving of these certificates where a large part of your capital is contributed by the membership that is using the coop and by revolving the certificates, the member realizes it is an investment and not a flat charge.

The Preferred Stock that a number of coops have can be considered as a permanent type of capital and I feel that in the years ahead where the coops will have the responsibilities, as Mr. Monroe pointed out, of particularly handling and processing most of their product, we need to consider ways of having more permanent capital.

Another important part of financing of coops is the hiring by the Board of Directors a good auditing firm and the auditing firm should, yes I would say <u>must</u>, be responsible to the Board of Directors so that they are aware of their financial condition. It is equally important that good management be hired and as a part of his responsibilities provide the Board of Directors a good monthly operating statement, covering current operations of the cooperative.

In conclusion, a cooperative, whether it be a milk coop, a grain coop, livestock or any other coop, to be successful must be well financed. It must have a Board of Directors that are willing to spend the time and effort to establish a sound fiscal policy, hire a capable manager, dedicated and willing to carry out those sound policies and hire an auditing firm to provide an annual audit report and perhaps meet with the Board of Directors at various times throughout the year. As our cooperatives are getting to be big business, they can and must be run on good sound business principles.

Response of Robert Brewer, President,
Cincinnati Cooperative Milk Sales Association

The subject is two-fold in application as reference is made to financing facilities and also marketing programs.

First, a milk marketing cooperative or a milk marketing division of a cooperative that markets raw milk for its patrons, collects and pays the patrons the proceeds from the sale of the milk, will need finances in addition to the regular dues collected from patrons. The additional funds are needed at times because of slow payments from receiving handlers and the resulting need for the cooperative to provide those funds in paying patrons. The cooperative then must have reserves or a line of credit sufficient to cover accounts receivable resulting from the sale of raw milk.

A cooperative's marketing program should be adequate to the service demands of members and the market and be adequately financed to provide an environment conducive to achieving the ultimate in fluid sales. This type of program benefits all patrons and the costs should be financed by all patrons.

Secondly, the facilities of a cooperative should be owned by the members. Each member should provide equity capital in direct proportion to his use of the cooperative and in sufficient amount over a period of time to fully finance ownership. Ownership should be vested in current membership, this is accomplished by a revolving plan and a capital refund plan to retiring members. I endorse the financing principles as enumerated by Mr. Monroe.

Short and long range planning and policy are necessary by management and boards of directors to avoid burdensome commitments. Board policy should not be determined by tradition but should accommodate actual needs. Board policy and management technique should be flexible to accommodate member and market requirements as changes occur in the industry.

Management practices and procedures used must be able to determine current financial positions and forecast future needs.

Financial reporting systems should be in specific detail to provide current information to management and to the Board. Cash flow systems are imperative and product cost systems are necessary to all processing plants.

Milk marketing cooperatives in and around Ohio should consider the need for facilities to handle surplus milk. This consideration should be made jointly by all cooperatives in the area. One large operation would be more practical than several small processing plants.